

City of Midland, Michigan

Management's Discussion and Analysis

CITY OF MIDLAND, MICHIGAN MANAGEMENT'S DISCUSSION AND ANALYSIS Year Ended June 30, 2005

As management of the City of Midland (the "City"), we offer readers of the City's financial statements this narrative overview and analysis of the financial activities of the City for the fiscal year ended June 30, 2005. We encourage readers to consider the information presented here in conjunction with additional information that we have furnished in our letter of transmittal, the financial statements, and the notes to the financial statements.

Financial Highlights

- The assets of the City exceeded its liabilities at the close of the most recent fiscal year by \$176,548,196. Of this amount, \$40,651,701 (unrestricted net assets) may be used to meet the government's ongoing obligations to citizens and creditors.
- The government's total net assets increased by \$12,131,854 during the fiscal year. Governmental activities accounted for \$9,589,153 of this increase, while business-type activities accounted for \$2,542,701. The increases are primarily due to a large reduction in the tax appeal reserve account, which is shown as a liability in government activities.
- At the end of the current fiscal year, the City's governmental funds reported combined ending fund balances of \$56,586,414, a decrease of \$7,142,182 in comparison with prior year. Approximately 79 percent of this total, or \$44,925,070, is reserved for various purposes. Of the remaining unreserved balance, \$1,099,691 is designated for specific purposes, leaving an unreserved, undesignated balance of \$10,561,653.
- At the end of the current fiscal year, unreserved fund balance for the General Fund was \$1,597,089, or 4.0 percent of total General Fund expenditures (including transfers).

Overview of the Financial Statements

This discussion and analysis is intended to serve as an introduction to the City's basic financial statements. The City's basic financial statements comprise three components: (1) government-wide financial statements, (2) fund financial statements, and (3) notes to the financial statements. This report also contains other supplemental information in addition to the basic financial statements themselves.

City of Midland, Michigan

Management's Discussion and Analysis (Continued)

Government-wide Financial Statements

The government-wide statements are designed to provide readers with a broad overview of the City's finances, in a manner similar to a private sector business.

The statement of net assets presents information on all of the City's assets and liabilities, with the difference between the two reported as net assets. Over time, increases or decreases in net assets may serve as a useful indicator of whether the financial position of the City is improving or deteriorating.

The statement of activities presents information showing how the government's net assets changed during the most recent fiscal year. All changes in net assets are reported as soon as the underlying event giving rise to the change occurs, regardless of the timing of related cash flows. Thus, revenues and expenses are reported in this statement for some items that will only result in cash flows in future fiscal periods (for example, earned but unused vacation leave).

Both of the government-wide financial statements distinguish functions of the City that are principally supported by taxes and intergovernmental revenues (governmental activities) from other functions that are intended to recover all or a significant portion of their costs through user fees and charges (business-type activities). The governmental activities of the City include general government, public safety, public works (highways and streets and other services), community development, sanitation, parks and recreation, library, airport, transportation, tax appeal defense, interest and agent fees, and other functions. The business-type activities of the City include a regional water distribution system, regional wastewater collection system, a sanitary landfill, a golf course, parking, and real estate rental (primarily two senior citizen housing facilities).

The government-wide financial statements can be found on pages 15-17 of this report.

Fund Financial Statements

A fund is a grouping of related accounts that is used to maintain control over resources that have been segregated for specific activities or objectives. The City, like other state or local governments, uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements. All of the funds of the City can be divided into three categories: governmental funds, proprietary funds, and fiduciary funds.

Governmental Funds - Governmental funds are used to account for essentially the same functions reported as governmental activities in the governmental-wide financial statements. However, unlike the government-wide financial statements, governmental fund financial statements focus on the near-term inflows and outflows of spendable resources, as well as on balances of spendable resources available at the end of the fiscal year. Such information may be useful in evaluating a government's near-term financing requirements.

City of Midland, Michigan

Management's Discussion and Analysis (Continued)

Because the focus on governmental funds is narrower than that of the government-wide financial statements, it is useful to compare the information presented for governmental funds with similar information presented for governmental activities in the government-wide financial statements. By doing so, readers may better understand the long-term impact of the government's near-term financing decisions. Both the governmental fund balance sheet and the governmental fund statement of revenues, expenditures, and changes in fund balances provide a reconciliation to facilitate this comparison between governmental funds and governmental activities.

The City maintains 14 individual governmental funds. Information is presented separately in the governmental fund balance sheet and in the governmental fund statement of revenues, expenditures, and changes in fund balances for the General Fund and the Major Street Fund, both of which are considered to be major funds. Data from the other 12 governmental funds are combined into a single, aggregated presentation. Individual fund data for each of these nonmajor governmental funds is provided in the form of combining statements elsewhere in this report.

The City adopts an annual budget for each of its governmental funds, except for the Cemetery and Capital Projects Funds. Budgetary comparison statements have been provided herein to demonstrate compliance with those budgets.

The basic governmental fund financial statements can be found on pages 18 through 21 of this report.

Proprietary Funds - The City maintains two different types of proprietary funds. Enterprise Funds are used to report the same functions presented as business-type activities in the government-wide statements. The City uses Enterprise Funds to account for water distribution, wastewater collection, sanitary landfill operations, downtown parking, senior citizen housing, and golf course operations. Internal Service Funds are an accounting device used to accumulate and allocate costs internally among the City's various functions. The City uses Internal Service Funds to account for equipment and fleet operations, data processing services, general and liability insurance, special assessment project funding, and bus garage operations. Because these services predominantly benefit governmental rather than business-type functions, they have been included within governmental activities in the government-wide financial statements.

Proprietary funds provide the same type of information as the government-wide financial statements, only in more detail. The proprietary fund financial statements provide separate information for the Water, Wastewater, Real Estate Rental, and Sanitary Landfill Funds, which are considered to be major funds of the City. The remaining Enterprise Funds and the Internal Service Funds are each combined into a single aggregated presentation in the proprietary fund financial statements. Individual fund data for the remaining Enterprise Funds and the Internal Service Funds is provided in the form of combining statements elsewhere in this report.

City of Midland, Michigan

Management's Discussion and Analysis (Continued)

The basic proprietary fund financial statements can be found on pages 22 through 31 of this report.

Fiduciary Funds - Fiduciary funds are used to account for the resources held for the benefit of parties outside the government. Fiduciary funds are not reflected in the government-wide financial statements because the resources of those funds are not available to support the City's own programs

The basic fiduciary funds financial statements can be found on page 32 and 33 of this report.

Notes to the Financial Statements - The notes provide additional information that is essential to a full understanding of the data provided in the government-wide and fund financial statements. The notes to the financial statements can be found on pages 34 through 68 of this report.

Other Information - In addition to the basic financial statements and accompanying notes, this report also presents certain required supplemental information concerning the City. This information can be found on pages 69 through 73 of this report.

The combining statements referred to earlier in connection with nonmajor governmental funds, nonmajor Enterprise Funds, and Internal Services Funds are presented immediately following the required supplemental information.

Government-wide Financial Analysis

As noted earlier, net assets may serve over time as a useful indicator of a government's financial position. In the case of the City, assets exceeded liabilities by \$176,548,196 at the close of the most recent fiscal year.

The largest portion of the City's net assets (70 percent) reflects its investment in capital assets (e.g., land, buildings, vehicles, equipment, and infrastructure), less any related debt used to acquire those assets that are still outstanding. The City uses these capital assets to provide services to citizens; consequently, these assets are not available for future spending. Although the City's investment in its capital assets is reported net of related debt, it should be noted that the resources needed to repay debt must be provided from other sources, since the capital assets themselves cannot be used to liquidate these liabilities.

City of Midland, Michigan

Management's Discussion and Analysis (Continued)

City of Midland's Net Assets (in 1,000's of dollars)

	Governmental Activities		Business-Type Activities		Total	
	2005	2004	2005	2004	2005	2004
Current and other assets	\$ 67,955	\$ 74,766	\$ 32,053	\$ 32,082	\$ 100,008	\$ 106,848
Capital assets	50,820	36,519	103,751	104,548	154,571	141,067
Total assets	118,775	111,285	135,804	136,630	254,579	247,915
Current liabilities	9,228	8,184	4,378	5,151	13,606	13,335
Long-term liabilities	40,659	43,792	23,766	26,362	64,425	70,154
Total liabilities	49,887	51,976	28,144	31,513	78,031	83,489
Net assets:						
Invested in capital assets, net of related debt	42,571	34,483	80,266	77,972	122,837	112,455
Restricted	11,840	9,586	1,219	1,219	13,059	10,805
Unrestricted	14,477	15,240	26,175	25,926	40,652	41,166
Total net assets	\$ 68,888	\$ 59,309	\$ 107,660	\$ 105,117	\$ 176,548	\$ 164,426

An additional portion of the City's net assets (7 percent) represents resources that are subject to external restrictions on how they are to be used. The remaining balance of unrestricted net assets (\$40,651,701) may be used to meet the government's ongoing obligations to citizens and creditors.

At the end of the current fiscal year, the City is able to report positive balances in all three categories of net assets, both for the governmental and business-type activities as a whole, as well as for its separate governmental and business-type funds. The same situation held true for the prior fiscal year.

The government's total net assets increased by \$12,131,854 during the fiscal year. Governmental activities accounted for \$9,589,153 of this increase, while business-type activities accounted for \$2,542,701. The increases are primarily due to a large reduction in the tax appeal reserve account, which is shown as a liability in government activities.

City of Midland, Michigan

Management's Discussion and Analysis (Continued)

City of Midland Changes in Net Assets (in 1,000's of dollars)

	Governmental Activities		Business-type Activities		Total	
	2005	2004	2005	2004	2005	2004
Revenue						
Program revenue:						
Charges for services	\$ 3,757	\$ 3,660	\$ 20,040	\$ 19,937	\$ 23,797	\$ 23,597
Operating grants and contributions	5,225	5,266	-	-	5,225	5,266
Capital grants and contributions	2,594	1,575	1,138	1,682	3,732	3,257
General revenue:					-	-
Property taxes	37,178	30,365	-	-	37,178	30,365
Intergovernmental	3,654	3,655	-	-	3,654	3,655
Investment earnings	1,567	1,223	634	461	2,201	1,684
Transfers and other revenue (expense)	(1,522)	(1,515)	1,784	2,122	262	607
Total revenue	52,453	44,229	23,596	24,202	76,049	68,431
Program Expenses						
General government	3,063	3,924	-	-	3,063	3,924
Public safety	10,988	9,711	-	-	10,988	9,711
Public works	5,075	6,905	-	-	5,075	6,905
Community development	403	728	-	-	403	728
Sanitation	2,088	2,239	-	-	2,088	2,239
Parks and recreation	3,893	4,021	-	-	3,893	4,021
Library	4,407	4,395	-	-	4,407	4,395
Transportation	1,517	1,507	-	-	1,517	1,507
Tax appeal defense	6,452	4,532	-	-	6,452	4,532
Other functions	4,786	4,103	-	-	4,786	4,103
Interest on long-term debt	192	29	-	-	192	29
Water	-	-	8,246	7,361	8,246	7,361
Wastewater	-	-	5,260	4,469	5,260	4,469
Landfill	-	-	3,483	2,507	3,483	2,507
Golf course	-	-	919	984	919	984
Parking system	-	-	154	186	154	186
Real estate rental	-	-	2,991	2,787	2,991	2,787
Total expenses	42,864	42,094	21,053	18,294	63,917	60,388
Change in Net Assets	\$ 9,589	\$ 2,135	\$ 2,543	\$ 5,908	\$ 12,132	\$ 8,043

City of Midland, Michigan

Management's Discussion and Analysis (Continued)

Governmental Activities

As mentioned above, governmental activities increased the City's net assets by \$9,589,153, due mostly to reducing the tax appeal reserve account, which is shown as a liability in government activities. Through the settlement of one of the three major tax appeals, and the application of decisions by the Michigan Tax Tribunal, the City was able to reduce its reserve by nearly \$9 million. This amount was recognized as property tax revenue on the statement of changes in net assets, and is included as unrestricted net assets, available to reduce future year mileage requirements. At year end, those funds were in cash equivalents in the DDA fund. A more detailed discussion follows:

- Capital grants and contributions revenue increased by \$1,018,676 over last year with the largest areas of increase coming in public works (\$824,503), and parks and recreation (\$150,718). The increase in public works is due to new privately developed subdivisions to supply new streets, sidewalks, and storm sewers. The increase in parks and recreation is due to donations for the new civic arena.
- Property tax revenue increased by \$6,812,782. As discussed later in Note 17 of the notes to the financial statements section of this report, the City is reserving net assets to fund potential unfavorable outcomes in two major tax appeal cases. This reserve is recorded as a long-term liability on the government-wide statements. Accordingly, any tax revenues collected to fund this reserve are recorded as an increase to the liability, rather than as property tax revenue. Conversely, any reductions to the liability are recorded as property tax revenue in the year of the reduction. In 2004, \$5,235,862 of property tax revenue on the governmental funds statement was applied to increase the liability on the government-wide statements. As a result, the property tax revenue shown on the government-wide statements was lower than that which was shown on the governmental fund statement. In 2005, the opposite is true. The liability was reduced by \$8,929,696. Therefore, while the governmental fund statement for 2005 includes \$7,287,446 less in property tax revenues due to a 3.03 mill reduction to the City's total millage, the government-wide statement shows greater property tax revenue than last year due to the reduction of the liability.
- Investment earnings increased by \$344,083 as a result of a slight recovery in the investment market.

City of Midland, Michigan

Management's Discussion and Analysis (Continued)

- Certain factors impacted both governmental and business-type activities: the City's workforce includes six collective bargaining units that provide for an average wage increase of 3 percent; health insurance costs increased 17 percent; the City's police and fire pension plan slipped below being its previous "over-funded" status and required approximately \$673,000 of City contributions; and pension costs for all other eligible employees increased by 7.7 percent. Last years' CAFR included a change in the allocation process of Internal Service Funds between governmental and business-type funds. The impact of this change resulted in an increase to governmental expenses of approximately \$1.3 million, with a decrease to business-type expenses by approximately the same. For the 2005 fiscal year, the allocation of the internal service operations for the year was to decrease governmental expenses by \$136,176 and decrease business-type expenses by \$230,419.
- Expenses for governmental activities increased by \$768,896 or 1.8 percent over prior year expenses. General government and public works expenses decreased significantly from last year, substantially due to the allocation change in 2004 as mentioned in the previous bullet. Public safety expenses increased by \$1,276,179, mostly due to increased pension, health insurance, and wage costs. Tax appeal defense expenses increased by \$1,919,502 as a result of the settlement with Dow Corning that provided them with a refund that included \$1,914,997 from the General Fund for prior year taxes.

Business-type Activities

Business-type activities increased the City's net assets by \$2,542,702. Key elements follow:

- Capital grants and contributions decreased by \$544,470 (29 percent). Most of the decrease was due to the completion of golf course improvements in the prior year, which were funded mostly by foundation contributions.
- Program expenses increased from last year by \$2,757,888. A large portion of this increase over 2004 is due to 2004's expenses being reduced by adjustments for the change in internal service (approximately \$1.3 million), and a reduction to landfill depreciation and final closer expense as a result of underestimating cell capacity in prior years. Aside from the effect of these non-reoccurring items, landfill expenses increased by approximately \$350,000 due to additional maintenance costs on previously closed cells and the donation of heavy equipment purchases to the Equipment Revolving Fund; Water Fund maintenance expenses increased by approximately \$270,000; and Wastewater Fund maintenance expenses increased by approximately \$300,000.

Financial Analysis of the Governments Funds

As noted earlier, the City uses fund accounting to ensure and demonstrate compliance with finance-related requirements.

City of Midland, Michigan

Management's Discussion and Analysis (Continued)

Governmental Funds - The focus of the City's governmental funds is to provide information on near-term inflows, outflows, and balances of spendable resources. Such information is useful in assessing the City's financing requirements. In particular, unreserved fund balance may serve as a useful measure of a government's net resources available for spending at the end of the fiscal year.

As of the end of the current fiscal year, the City's governmental funds reported combined ending fund balances of \$56,586,414, a decrease of \$7,142,182 from the prior year. Approximately 21 percent of this total amount (\$11,661,343) constitutes unreserved fund balance, which is available for spending at the government's discretion. The remainder of the fund balance is reserved to indicate that it is not available for new spending because it has already been committed to a variety of restricted purposes, with the largest reserve being for tax appeals (\$38,410,155). See Note 17 in the Notes to the Financial Statements section of this report for more information on the tax appeals.

The General Fund is the chief operating fund of the City. At the end of the current fiscal year, unreserved fund balance of the General Fund was \$1,597,089, or 4 percent of total General Fund expenditures. The fund balance of the City's General Fund decreased by \$6,942,707 during the current fiscal year. This is mainly due to a reduction in the fund balance tax appeal reserve, as discussed elsewhere in this report.

The Major Street Fund and General Construction Fund are also major funds of the City. At the end of the current fiscal year, unreserved fund balances for each of these funds were \$6,962,204 and \$912,267, respectively. The Major Street Fund's net assets increased by \$1,734,314 during the year as a result of accumulated funding for projects that were not completed by fiscal year end. The General Construction Fund's net assets increased by \$442,235 during the year due to the same reason.

Proprietary Funds - The City's proprietary funds provide the same type of information found in the government-wide financial statements, but in more detail.

The Enterprise Funds operations for the current year resulted in an increase to net assets of \$2,312,283. The Water and Wastewater Funds had increases of \$1,627,391 and \$1,387,905, respectively. Both of these funds set their user fees to allow accumulation of reserves for capital investment and debt service. The increase in net assets reflects the result of this process. The Sanitary Landfill Fund had a decrease in net assets of \$209,592. This was a planned reduction to partially consume previously accumulated net assets. The Real Estate Rental Fund had a planned decrease of \$317,005. The Real Estate Rental Fund is comprised mainly of two senior housing facilities. The annual operating plans for these facilities set revenue rates to cover all annual operating costs. They do not provide excess revenue to contribute to a sinking fund for facility replacement. As such, this fund typically shows an annual reduction to net assets in an amount similar to the depreciation expense for that year.

City of Midland, Michigan

Management's Discussion and Analysis (Continued)

General Fund Budgetary Highlights

Differences between the original budget and the final budget were minimal. In general, total revenues and transfers in were greater than budgeted, and expenditures and transfers out were less than budgeted. Public safety expenditures were over budget by \$73,011, mostly due to labor contract settlement issues that were different than anticipated when the budget for the year was approved.

Capital Asset and Debt Administration

The City's investment in capital assets for its governmental and business-type activities as of June 30, 2005 amounts to \$154,570,190 (net of accumulated depreciation). This investment in capital assets includes land, land improvements, buildings, systems, machinery and equipment, streets, bridges, and sidewalks. The total increase in the City's investment in capital assets for the current fiscal year was \$13,503,695 (a 9 percent increase for both governmental and business-type activities).

Major capital asset events during the current fiscal year included the following:

- 70 percent of the construction of a new \$10 million Civic Arena
- 90 percent of a \$2.5 million improvement to the storm water collection system
- 90 percent of the construction of a \$.5 million airport terminal building
- \$3.3 million in major and local street improvements
- \$1.9 million in water and wastewater system improvements
- The City's replacement plan of vehicles and equipment continued.

Additional information on the City's capital assets can be found in Note 5 on pages 49 through 52 of this report.

City of Midland, Michigan

Management's Discussion and Analysis (Continued)

City of Midland Capital Assets (in 1,000's of dollars)

	Governmental Activities		Business-type Activities		Total	
	2005	2004	2005	2004	2005	2004
Land	\$ 3,369	\$ 3,159	\$ 2,317	\$ 2,317	\$ 5,686	\$ 5,476
Construction in progress	14,040	6,885	976	3,559	15,016	10,444
Major and local roads	8,425	3,131	-	-	8,425	3,131
Sidewalks	259	76	-	-	259	76
Buildings and improvements	22,943	21,105	70,441	70,417	93,384	91,522
Land improvements	1,885	1,231	5,543	5,546	7,428	6,777
Water and sewer lines	-	-	71,969	66,473	71,969	66,473
Landfill improvements	-	-	9,798	9,794	9,798	9,794
Library circulation materials	6,576	6,401	-	-	6,576	6,401
Equipment	8,522	8,198	4,715	4,979	13,237	13,177
Vehicles	13,219	12,588	580	597	13,799	13,185
Total	79,238	62,774	166,339	163,682	245,577	226,456
Less accumulated depreciation	(28,418)	(26,255)	(62,589)	(59,134)	(91,007)	(85,389)
	\$ 50,820	\$ 36,519	\$ 103,750	\$ 104,548	\$ 154,570	\$ 141,067

Long-term Debt

At the end of the current fiscal year, the City had total bonded debt outstanding of \$30,234,063. Of this amount, \$24,459,063 comprises debt backed by the full faith and credit of the government. The remainder of the City's debt is backed solely by specified revenue sources.

City of Midland Outstanding Debt General Obligation and Revenue Bonds (in 1,000's of dollars)

	Governmental Activities		Business-type Activities		Total	
	2005	2004	2005	2004	2005	2004
General obligation bonds	\$ 6,750	\$ 385	\$ 17,709	\$ 19,466	\$ 24,459	\$ 19,851
Revenue bonds	-	-	5,775	7,110	5,775	7,110
Total	\$ 6,750	\$ 385	\$ 23,484	\$ 26,576	\$ 30,234	\$ 26,961

The City's total bonded debt increased by \$3,273,177 during the fiscal year, reflecting the issuance of \$6.5 million of new debt relating to the construction of the Civic Arena, coupled with timely principal payments.

City of Midland, Michigan

Management's Discussion and Analysis (Continued)

The City maintains an AA rating with Standard and Poor's and an A1 rating with Moody's for the issuance of general obligation debt.

State statutes limit the amount of general obligation debt a government entity may issue to 10 percent of its total assessed valuation. Currently, 10 percent of assessed valuation is approximately \$270 million.

Additional information on the City's long-term debt can be found in Note 9, on pages 55 through 58 of this report.

Economic Factors and Next Year's Budgets and Rates

Positive developments in the major tax appeals have enabled the City to refund approximately \$6.5 million in excess reserves to the citizens. This refund from the fund balance reserved for tax appeals of the General Fund was given to the citizens in the form of a 2.63 negative millage. In total, the City millage rate is decreasing from 9.87 mills at July 2004 to 9.79 mills at July 2005. Note 17 of the Notes to the Financial Statements provides additional information on the tax appeals.

The 2005-2006 budget includes the first year of implementation of a Geographic Information System (GIS). This initiative will impact future expenditures of the General Fund, Wastewater Fund, Water Fund, Local Street Fund, and Major Street Fund. The Wastewater Fund increased its user rates for the 2005-2006 fiscal year in order to fund its portion of GIS, as well as to keep pace with increases in operating costs.

Requests for Information

This financial report is designed to provide a general overview of the City's finances for all those with an interest in the government's finances. Questions concerning the information provided in this report or requests for additional financial information should be addressed to the Finance Department at the Midland City Hall, 333 W. Ellsworth Street, Midland, MI 48640. Finance Department staff can be reached at 989-837-3322 or at cityhall@midland-mi.org. Additional information can be obtained at the City's website, www.midland-mi.org.